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PLR-116369-08

Date:

July 31, 2008

Re:

Distributing =

Controlled =

State X =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Shareholder 1 =

Shareholder 2 =

A Trust =

B Trust =

C Trust =

D Trust =

E Trust =

F Trust =

G Trust =

H Trust =

Beneficiary 1 =

I Trust =

J Trust =

K Trust =

L Trust =

M Trust =

N Trust =

Beneficiary 2 =

bb =

cc =

dd =

Business 1 =

Business 2 =

Business 3 =

LLC1 =

Dear :

We respond to your representative's letter dated April 3, 2008, requesting rulings as to the Federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondence is summarized below.

Summary of Facts

Distributing is a closely held, State X corporation that was incorporated on Date 1. Distributing made a Subchapter S election on Date 2 (more than 10 years ago). Distributing is engaged in Business 1, Business 2 and Business 3. Distributing has submitted financial information which indicates that Business 1 and Business 2 have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years. Some of the Business 2 assets and liabilities are in LLC1, which is wholly owned by Distributing and which Distributing represents is a disregarded entity.

Distributing has three classes of common stock: (1) Class A voting stock;

(2) Class B nonvoting stock; and (3) Class C voting stock. Shareholder 1 and Shareholder 2, together with family trusts, own all the issued and outstanding Distributing Class A stock. A Trust, B Trust, C Trust, D Trust, E Trust, F Trust, G Trust, and H Trust (“Beneficiary 1 Trusts”) and I Trust, J Trust, K Trust, L Trust, M Trust, and N Trust (“Beneficiary 2 Trusts”) own respectively bb percent and cc percent of the issued and outstanding shares of Distributing Class A stock.

On Date 3, Distributing issued to Beneficiary 1 nonstatutory stock options in exchange for services. The options entitle Beneficiary 1 to acquire dd shares of Distributing Class A stock. The options were not issued pursuant to an incentive stock option plan that was approved by the shareholders of Distributing. The options are not actively traded on an established market. The grant of the options is subject to the Distributing Stock Option Agreement (Agreement). The Agreement provides that the options shall not be transferable by Beneficiary 1 except by will or the laws of descent and distribution and shall be exercisable during Beneficiary 1’s lifetime only by Beneficiary 1.

Distributing incorporated Controlled in State X on Date 4 to effectuate the proposed transaction (“Proposed Transaction”). Controlled has two classes of authorized and outstanding stock: Class A voting common stock and Class B nonvoting preferred stock. Controlled is wholly owned by Distributing. Distributing filed Form 8869 (“Qualified Subchapter S election Classification”) (“QSUB Election”) to treat Controlled as a qualified Subchapter S subsidiary (“QSUB”) of Distributing, effective as of the date of incorporation.

Each nonstatutory stock option held by Beneficiary 1 that is outstanding immediately before the Proposed Transaction will be exchanged for an option to acquire Controlled Class A Stock with the same terms and conditions as the option to acquire Distributing Class A Stock. None of the options to acquire Distributing Class A Stock had a readily ascertainable fair market value within the meaning of § 1.83-7(b) of the Income Tax Regulations at the time the options were granted. None of the options to acquire Controlled Class A Stock will have a readily ascertainable fair market value within the meaning of § 1.83-7(b) at the time the options are granted.

For what are represented to be valid business purposes, Distributing proposes the following Proposed Transaction:

- (i) Distributing proposes to transfer to Controlled its entire membership interest in LLC1 and Business 2 and Business 3 assets and liabilities (the “Contribution”). The assets of Business 2 include trade receivables, inventory, machinery, equipment, licenses, trademarks, and other assets. The liabilities that will be transferred include trade payables, accrued compensation, and other current liabilities related to Business 2.

- (ii) Distributing proposes to distribute all of the issued and outstanding shares of Controlled Class A stock in exchange for all of the shares of Distributing Class A stock held by the Beneficiary 1 Trusts and the Beneficiary 2 Trusts and all of the issued and outstanding shares of Controlled Class B stock to Shareholder 1 in exchange for a portion of the Distributing Class A stock held by Shareholder 1 (the "Distribution"). Beneficiary 1 Trusts, Beneficiary 2 Trusts and Shareholder 1 are hereinafter referred to as the "Exchanging Shareholders".

Representations

The following representations have been made with respect to the Proposed Transaction:

- (a) The fair market value of the Controlled stock to be received by the Exchanging Shareholders will be approximately equal to the fair market value of the Distributing stock surrendered by the Exchanging Shareholders in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by any of the Exchanging Shareholders as creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees, except that Distributing and Controlled will be a party to a Transitional Services Agreement whereby certain services will be provided by one entity to the other following the Distribution.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purposes: to resolve shareholder and management conflicts, fit and focus, to create operational efficiencies, for risk alignment and liability protection, and to reduce the likelihood of unionization of certain workers. The distribution of the stock of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (f) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.

- (g) No investment credit property is deemed to be transferred between Distributing and Controlled as part of the Proposed Transaction.
- (h) No consideration will be issued by Controlled to Distributing except for Controlled stock deemed issued upon the termination of the QSUB election of Controlled immediately prior to the Distribution.
- (i) The total adjusted bases and the fair market value of the assets deemed to be transferred to Controlled by Distributing each will equal or exceed the sum of the liabilities deemed to be assumed (as determined under § 357(d)) by Controlled; and the liabilities deemed assumed (as determined under § 357(d)) in the transaction were incurred in the ordinary course of business and are associated with the assets deemed to be transferred.
- (j) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in § 355(d)(5) and (d)(8)) during the five-year period (determined after applying § 355(d)(6)) ending on the Distribution date.
- (k) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the Distribution date, or (ii) attributable to dispositions on Distributing stock that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the Distribution date.
- (l) No two parties to the transaction are investment companies as defined in §§ 368(a)(2)(F)(iii) and (iv).
- (m) Distributing is an S corporation (within the meaning of § 1361(a)). Immediately following the Proposed Transaction, Controlled will elect to be an S corporation pursuant to § 1362(a). There is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.
- (n) No intercorporate debt will exist between the Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.

- (o) Payments made in connection with all continuing transactions between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (p) The Distribution is not part of a plan or series of related transactions (within the meaning of § 1.355-7) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50 percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).

Rulings

Based solely on information submitted and the representations set forth above, we rule as follows:

- (1) The Distribution will cause a termination of the QSUB election of Controlled because Controlled will cease to be a wholly-owned subsidiary of an S corporation. Upon the Distribution, Controlled will be treated as a new corporation acquiring all of its assets and assuming all of its liabilities immediately before the termination of Controlled's QSUB election in exchange for the stock of Controlled (the Contribution) (§§ 1361(b)(3)(B) and (C)).
- (2) The Contribution, followed by the Distribution, will constitute a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled each will be "a party to the reorganization" within the meaning of § 368(b).
- (3) No gain or loss will be recognized by Distributing upon the Contribution. (§§ 357(a) and 361(a)).
- (4) No gain or loss will be recognized by Controlled on the Contribution (§1032(a)).
- (5) The basis of each asset received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing immediately prior to its transfer (§ 362(b)).
- (6) The holding period of each asset received by Controlled from Distributing in the Contribution will include the holding period of such asset in the hands of Distributing (§ 1223(2)).
- (7) No gain or loss will be recognized by Distributing upon the Distribution (§361(c)).

- (8) No gain or loss will be recognized by (and no amount will be included in the income of) the Exchanging Shareholders upon their receipt of Controlled stock in exchange for their Distributing stock in the Distribution (§ 355(a)).
- (9) The aggregate basis of the Controlled stock in the hands of the Exchanging Shareholders immediately after the Distribution will be the same as the aggregate basis of the Distributing stock, immediately before the Distribution, exchanged therefor by the Exchanging Shareholders (§§358(a) and (b)). If the Distributing stock held by Shareholder 1 immediately before the Distribution has different bases (e.g., shares of stock were acquired at different times and at different prices), the bases of the Distributing blocks of shares will be allocated between the Controlled blocks and his retained Distributing blocks (block by block allocation). If the Distributing stock held by the Beneficiary 1 Trusts and the Beneficiary 2 Trusts immediately before the Distribution has different bases (e.g., shares of stock were acquired at different times and at different prices), the bases of the Distributing blocks of shares will be allocated to the Controlled blocks (block by block allocation).
- (10) The holding period of the Controlled stock received by the Exchanging Shareholders will include the holding period of their Distributing stock surrendered in the Distribution, provided such shares of Distributing stock are held as capital assets in the hands of the Exchanging Shareholders at the time of the Distribution (§ 1223(1)).
- (11) Distributing's accumulated adjustments account immediately prior to the Distribution will be allocated between Distributing and Controlled in a manner similar to the manner in which Distributing's earnings and profits will be allocated under § 312(h) and § 1.312-10(a) (§ 1.1368-2(d)(3)).
- (12) Distributing's momentary ownership of the stock of Controlled, as part of the reorganization under § 368(a)(1)(D), will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B). Controlled may, without requesting the Commissioner's consent, make an S election before the expiration of the five-year period described in § 1361(b)(3)(D) and § 1361-5(c)(1), provided that:
 - (i) immediately following the termination, Controlled is otherwise eligible to make an S election; and
 - (ii) the election is made effective immediately following the termination of the QSUB election (§ 1.1361-5(c)(2)).
- (13) Controlled will not be subject to the built-in gain provisions of § 1374.

- (14) Section 83 will not apply to the options to acquire Controlled Class A stock that Beneficiary 1 will receive pursuant to the Proposed Transaction because the options will not have a readily ascertainable fair market value on the date of acquisition. Section 83 will apply when these options are exercised or otherwise disposed of (§§ 83(a) and (b) and §§ 1.83-7(a) and (b)(2)).
- (15) No gain or loss will be recognized by Distributing or Controlled upon the granting of the Beneficiary 1 Controlled stock options in replacement of the Beneficiary 1 Distributing stock options.

Caveats

We express no opinion about the tax treatment of the facts described above under any other provision of the Code or Regulations, or the tax treatment of any conditions existing at the time of, or effects resulting from, these facts that are not specifically covered by the above ruling.

In particular, this Office has not reviewed any information pertaining to, and has made no determination regarding, whether the Distribution: (i) satisfies the business purpose requirement of § 1.355-2(b), (ii) is being used principally as a device for the distribution of earnings and profits of Distributing or Controlled or both (see §§355(a)(1)(B) and § 1.355-2(d)), or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50 percent or greater interest in Distributing or Controlled (see §§355(e) and § 1.355-7). Except as specifically ruled upon above, no opinion is expressed concerning whether either Distributing or Controlled is, in fact, an S corporation for Federal tax purposes or concerning whether any particular shareholder of Distributing or Controlled is an eligible S corporation shareholder. Also, no opinion was requested, and none is expressed or implied, regarding the Federal tax treatment of the transitional services; the Federal tax treatment of any agreements regarding intellectual property; and the application of § 409A or any other provision to the options in ruling (14).

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This Office has not verified any of the materials submitted in support of the taxpayer's ruling request. Verification of this material may be required as part of the audit process.

Procedural Statements

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Filiz A. Serbes

Filiz A. Serbes
Chief, Branch 3
Office of Associate Chief Counsel
(Corporate)